Reforming Finance To Promote The Capital Development Of The Economy: A Keynes-Schumpeter-Minsky Synthesis

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Overview

• The financial system has been transformed into little more than high stakes gambling, putting our economy at risk of serial bubble-and-bust cycles.

• It no longer serves us well, indeed, it actually impedes growth of employment with rising living standards.

• We will synthesize the insights of Keynes, Schumpeter and Minsky to formulate a strategy that will promote the capital development of the economy.

• To do that, we must reform finance to redirect it to financing development, broadly construed to include private investment, investment in our labor force, and public infrastructure investment.
Overview: Keynes

• From Keynes: the central insight of the theory of effective demand:
  – Firms hire the resources they think they will need to produce what they think they can sell.
  – Employment is not determined in labor markets—but rather by the level of sales expected.
  – Rejection of loanable funds theory.

• “Investment theory of the cycle.”
Overview: Schumpeter

• From Schumpeter we borrow two insights:
  a) link between innovation process and the dynamics of the capitalist economy, and
  b) innovation needs finance.
  – Innovation must be financed before it can generate revenues. Banker as Ephor
  – That is most obvious in the case of start-ups.
  – Modification needed for the case of large, complex, and well-capitalized firms: internal finance (but avoid infinite regress: Neo-Schumpeterians/New Institutionalists).
  – Entrepreneurial state!
Overview: Minsky

• Forces of the capitalist system are not stabilizing; adding finance, dynamics become worse.

• Minsky broadened Schumpeter’s view—not simply finance for innovation, as investment is typically externally financed.

• We can go further: all production must be financed (M-C-M’: Marx and Keynes). Banker is Ephor!

• Finance, itself, is subject to innovation.

• Finally, “stability is destabilizing”, mainly due to innovations in finance that are encouraged by the appearance of stability.
MINSKY’S Early Contributions

• Innovation is endogenous, responds to profit opportunity: fed funds mkt, endog Ms

• Innovation stretches liquidity, increases fragility, reduces margins of safety

• Intervention validates innovations

• Multiplier-Accelerator with ceilings and floors: time path can be steady growth, cycles, booms, long depressions; depends on institutions

• Institutions of early post war economy promoted stability; but stability is destabilizing
Extensions: 1960s-1970s

- **JMK: financial theory of investment**
  - 2 Price system
  - Lender’s and Borrower’s risk

- **Kalecki view of profits**
  - I today forthcoming only if I expected in future
  - Def stabilizes profit

- **Financial Instability Hypothesis**
  - Apparent stability changes expectations and behavior in a way that generates fragility
The Policy Problem

• Stability cannot be achieved because it changes behavior in ways that make “it” likely.

• “The policy problem is to devise institutional structures and measures that attenuate the thrust to inflation, unemployment, and slower improvements in the standard of living without increasing the likelihood of a deep depression.”

• Relative stability of Post-War period led to development of a much more unstable version of the “57 Varieties of Capitalism”.
The Great Moderation: It can’t happen again

- World is now more stable, due to:
  - Better monetary management: dampened inflation and business cycle swings
  - Globalization, absorbs shocks
  - Improvements in information technology
  - Rising profits, declining corporate leverage
  - Securitization → risks managed and allocated
  - Derivatives ensure against risk

Minsky: A Radical Suspension of Disbelief
A Minsky Moment or a Minsky Half-Century?

• Stages Approach 1980s-90s
  – Commercial capitalism
  – Finance capitalism
  – Paternalistic (Managerial-Welfare State) capitalism
  – Money Manager capitalism (predator state, financialization, ownership society, neoliberalism, neoconservativism, shadow banking)
    • Stability bred instability
    • Accumulation of financial assets/liabilities
    • Globalization
    • Securitization
    • Self-supervision
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Boom and Bust

• 1980s Thrift & Bank Crises
  – Thrifts and Commercial real estate
  – Banks and LDC debt

• 1980s Leverage Buy-outs
  – Michael Milken and Junk Bonds

• 1990s New Economy and Nasdaq
  – “Irrational Exuberance”

• 2000s Residential Real Estate
  – Subprimes; foreclosures

• 2000s Commodity Markets
  – Quadrupled oil prices; food riots; starvation

Increasingly frequent and each crisis is worse than the previous
Virtuous Cycle

- Stability
- Innovation
- Competition
- Asset Prices
- Leverage
- Credit Availability
Total Financial Liabilities Relative to GDP

How did Consumption become Destabilizing?

• Investment theory of the cycle and financial theory of investment

• Kalecki: Profit = I + Def + NX – Sw + Cp

• What if Sw < 0?

• Minsky 1963: private-sector led expansion inherently unstable

• Financed consumption drives the cycle?
Fragility Rises as wage share falls but consumption share rises

• Stagnant real wages, and falling wage share since early 1970s
• Low wage competition, union busting
• Debt-fueled consumption
• Rising share of financial sector
Profits Grow relative to GDP
Sector Financial Balances as a % of GDP, 1952q1 to 2010q3
Policy Response after GFC

- Policy actions were directed at saving the system, not reforming it
- Too big to fail institutions even bigger today than they were before the crisis
- Few criminal prosecutions of those responsible for the current crisis
- Reliance on Wall Street to reform itself, belief that gov’t only needs to get the incentives right for market discipline to work
Toward a New Paradigm

• Government-Centered Approach
  – Sovereign Currency
  – Public Purpose of Monetary System: create and mobilize resources

• Analysis Disciplined with Balance Sheets
  – Financial Assets = Financial Liabilities
  – Stock-Flow Consistent Modeling
  – Macro Sectoral Balances
Modern Money View

• Money is not primarily a medium of exchange
• Money is not primarily a means of circulation
• Money is a State Monopoly, unit of acct
• Banks make payments for customers, in bank IOUs denominated in State’s money
• Banks (and shadow banks) are highly leveraged
• Contingent monetary claims are orders of magnitude bigger than capital, safe and liquid assets, and income and production
Revised View of Fiscal Policy

- Sovereign Issuer of Currency
  - Spends by Crediting Accts, Taxes by Debiting
- Sovereign Cannot Borrow
  - Bond Sales Are Part of Monetary Policy
- Sovereign Supplies Net Financial Saving
  - Govt Deficit $\rightarrow$ Nongovt Surplus
- Fiscal Policy Dominates
  - Appropriate Goals: Full Employment with Price Stability; Rising Living Standard
Revised View of Monetary Policy

• Interest Rate Target → Horizontal Reserves
  – Reserves Are Nondiscretionary
  – Reserves Are Not A Constraint

• Effects of Rate Change Indeterminant
  – In usual circumstances, lower rate → deflationary

• Central Bank Is Never Independent

• Best Practice: Pay 25bp on Reserves, Lend at 50bp, Operate Clearing for Treas & Banks
Revised View of Finance

• Conventional View: intermediated saving; Modigliani-Miller, Efficient Mkts Hypoth
  – Saving don’t finance nothing
  – The “Finance” Is Created Simultaneously with the Spending (System of Credits and Debits)

• Financialization Is Not Finance; It is Leverage or Layering
  – Securitized Mortgages, Life Settlements, Private Pensions, Health Care “Reform” = Financialization
  – Finance is Not a Scarce Resource
  – Wall St Became the Tail that Wags the Dog
Minsky’s Wall St view of money

- Vast majority of monetary transactions have little to do with circulating or producing output
  - Barter or Circular flow view: ignores most of the recent developments and problems
  - MTP, M-C-M’ somewhat more useful
- Many are related to financing positions in assets: M now for more M later; issuing an IOU to get IOUs later
  - The M now is usually collateralized borrowing: “other people’s money”
- Or: changing characteristics of income and outgo streams: r and x swaps
- Many are hedges and bets on contingent outcomes
What do Banks do?

- Not Money Lenders
- Not Intermediaries betw savers and investors
- Instead:
  - Accept IOUs
  - Make payments for customers using own IOUs
  - Most of the time that means paying another bank
    - With banks net clearing acct with govt’s IOUs
  - Or making payments to government
    - Using govt’s own IOUs
    - Facilitated by central bank
Banks as Public-Private Partners

- Clearing at par requires access to central bank
- Safety requires gov’t backing of deposits; in a crisis, 100%
- Hence “private” bank plays with “house money” → public-private partnership (PPP); requires close supervision/regs
- If banks are backstopped by govt, mkt incentives are weak
- Private lending justified only if banks are better underwriters than govt is
- Loans must be held to maturity to induce proper underwriting
- Relationship banking rather than markets
  - Finance is not a scarce resource to be allocated by efficient mkt
What *Should* Financial System Do?: Key Elements to Promote Capital Development

- 1. safe and sound payments system;
- 2. short term loans to households and firms, and, possibly, to state and local government;
- 3. safe and sound housing finance system;
- 4. a range of financial services including insurance, brokerage, and retirement savings services; and
- 5. long term funding of positions in expensive capital assets.

NB: there is no reason why these should be consolidated, nor why all should be privately supplied
Reconstituting the Financial System

• Minsky Project: Reconstituting Finance to Promote Capital Development of the Economy

• Requires Proper Framework
  – 1. a capitalist economy is a financial system;
  – 2. neoclassical economics is not useful because it denies that the financial system matters;
  – 3. the financial structure has become much more fragile;
  – 4. this fragility makes it likely that stagnation or even a deep depression is possible;
  – 5. a stagnant capitalist economy will not promote capital development;
  – 6. however, this can be avoided by apt reform of the financial structure in conjunction with apt use of fiscal powers of the government.
Minsky’s policies to promote stability

• High consumption, high employment
  – Greater equality, rely on income, not debt

• Favor small to medium size banks; CDBs, not predatory lending; debt relief

• Institutions and practices to favor stability
  – Automatic stabilizers: countercyclical budget
  – Institutional Circuit breakers

• No “final” solution to fundamental flaw of capitalism
THANK YOU

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